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Expert Analysis

‘U.S. v. Martoma’: The End of the ‘Newman’ Personal Benefit Test

By
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Less than three years after the U.S. Court of Appeals for the Second Circuit instituted a new test for the personal benefit element of insider trading violations in *United States v. Newman*, 773 F.3d 438 (2d Cir. 2014), the Court of Appeals in *United States v. Martoma*, No. 14-3599 (2d Cir. Aug. 23, 2017), expressly overruled the remaining vestiges of that test, which had already been narrowed by the U.S. Supreme Court in *Salman v. United States*, 137 S. Ct. 420 (2016).

The recent cases all addressed the Supreme Court’s seminal decision in *Dirks v. SEC*, 463 U.S. 646 (1983), which held that liability for insider trading under §10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder requires the insider disclosing material nonpublic information to have received or expected a personal benefit in exchange for disclosing the information. *Dirks* provided a broad definition of personal benefit, holding that it could be satisfied by (among other things) “a gift of confidential information to a trading relative or friend.” 463 U.S. at 664.

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In a 2-1 decision, the Court of Appeals in *Martoma* held that *Newman*’s gloss of a “meaningfully close personal relationship” as part of the personal benefit test was “no longer good law.” Slip Op. at 24. Instead, the majority ruled, liability requires the government to prove that the tipper expected the tippee would trade on the information and the tip “resembled trading by the insider followed by a gift of the profits” to the tippee. Id. at 26.

From ‘Dirks’ to ‘Salman’

In the United States, unlike other jurisdictions, merely trading on material nonpublic information is not enough to incur liability: There must also be a breach by the tipper of a fiduciary duty or other duty of trust and confidence. In the 1980s, the Supreme Court established the principle that the federal securities laws do not “create a system [of] providing equal access to information necessary for reasoned and intelligent investment decisions.” *Chiarella v. United States*, 445 U.S. 222, 232 (1980). In *Dirks*, the Supreme Court held that the test for what constitutes a breach of fiduciary duty is whether the tipper “personally benefits, directly or indirectly, from the disclosure.” Id. at 662. The court elaborated that personal benefit can mean not just pecuniary gain, but also “a reputational benefit that will translate into

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future earnings," and that "objective facts and circumstances [] often justify" an inference of benefit. Id. at 663-64. Examples of such "facts and circumstances" include "a relationship between the insider and the recipient that suggests a quid pro quo from the latter, or an intention to benefit the particular recipient." Id. at 664. The elements of improper exploitation of nonpublic information "also exist when an insider makes a gift of confidential information to a trading relative or friend." Id. The Supreme Court reasoned: "The tip and trade resemble trading by the insider himself followed by a gift of the profits to the recipient." Id. The concept of information as a gift plays a pivotal role in both *Salman* and *Martoma*.

Prior to *Newman* (and in post-*Newman* decisions in other circuits), prosecutors and courts proceeded as though *Dirks*' reference to "a gift … to a … friend" set a low bar.[1] In an effort to limit the scope of insider trading liability, the *Newman* panel imposed an additional hurdle: It held that personal benefit could not be inferred from a personal relationship absent "proof of a meaningfully close personal relationship that generates an exchange that is objective, consequential, and represents at least a potential gain of a pecuniary or similarly valuable nature." 773 F.3d at 442. Although the court did not delineate the contours of a "meaningfully close personal relationship," it held that the fact that the tipper (a corporate insider) and the tippee (an analyst at an investment firm) were business school classmates who had worked together at the same company and known each other for years was insufficient to establish personal benefit where the tippee testified the two were not "close friends." Id. at 452.

A unanimous Supreme Court in *Salman v. United States*, 137 S. Ct. 420, 428 (2016), rejected the latter part of *Newman*'s personal benefit test—the need for evidence that the tipper stands to receive something "of a pecuniary or similarly valuable nature." However, because the case involved tipping between two brothers who were admittedly "very close," and *Dirks* specifically contemplated "a gift of confidential information to a trading *relative*," the court did not address *Newman*'s "meaningfully close personal relationship" requirement. The Supreme Court held that it was "adher[ing] to *Dirks*, which easily resolve[d] the narrow issue presented." 137 S.Ct. at 427.

The Supreme Court's analysis of *Dirks* in *Salman* emphasized the gift-giving aspect of the conduct. The tipper, Maher Kara, was an investment banker with access to merger information; he tipped his brother, Michael Kara, who executed trades and passed the information to his friend (and future brother-in-law), Salman, who also traded. The court reasoned that making a gift of inside information to a relative like Michael was "little different from trading on the information, obtaining the profits, and doling them out to the trading relative." 137 S.Ct. at 428. The court pointed to the fact that "[i]n one of their tipper-tippee interactions, Michael asked Maher for a favor, declined Maher's offer of money, and instead requested and received lucrative trading information." Id.

The 'Martoma' Decision

In *Martoma*, the tippers were doctors involved in a clinical drug trial of an experimental drug being developed by two health care companies. The doctors engaged in paid consulting calls through expert networking firms with Martoma, a hedge fund portfolio manager trading in the stocks of the health care companies, in which the doctors passed confidential information about the clinical trial. In two instances, the key doctor disclosed the most valuable information at issue in the case without being paid for the consultations. The jury was instructed, pre-*Newman*, that it could find a personal benefit if (among other things) one of the doctors disclosed the information "as a gift with the goal of maintaining or developing a personal friendship or a useful networking contact." Slip Op. at 12. The defendant argued on appeal that he and the key doctor were not sufficiently "close" to meet *Newman*'s "meaningfully close personal relationship" test, which survived *Salman*, and the jury instruction allowing a finding of personal benefit based on developing a *future* friendship contravened *Newman*.

Writing for a divided panel, Chief Judge Robert A. Katzmann held that the logic of *Salman* meant that

"*Newman*'s 'meaningfully close personal relationship' requirement can no longer be sustained." Slip. Op. at 19-20. Pointing to *Salman*'s focus on *Dirks*' gift-giving analogy, the court ruled: "Nothing in *Salman*'s reaffirmation of this logic supports a distinction between gifts to people with whom a tipper shares a 'meaningfully close personal relationship'—a term left undefined in *Newman*, but which apparently did not reach two people who 'had known each other for years, having both attended business school and worked … together,' 773 F.3d at 452—and gifts to those with whom a tipper does not share such a relationship." Slip Op. at 26. Rather, the Chief Judge explained, "an insider or tipper personally benefits from a disclosure of inside information whenever the information was disclosed 'with the expectation that [the recipient] would trade on it,' Salman, 137 S.Ct. at 428, and the disclosure 'resemble[s] trading by the insider followed by a gift of the profits to the recipient,' id. at 427 … , whether or not there was a 'meaningfully close personal relationship' between the tipper and tippee." Slip Op at 27-28. Under this framework, the district court's jury instruction "on gifts with the goal of developing friendships … did not constitute obvious error." Slip Op. at 35 (internal citation omitted).

In a strongly-worded dissent, Judge Rosemary S. Pooler expressed concern that the majority's decision weakens the personal benefit rule and removes an important limitation on prosecutorial power. Judge Pooler explained that "[w]hat counts as a 'gift' is vague and subjective.[2] Juries, and more dangerously, prosecutors, can now seize on this vagueness and subjectivity. The result will be liability in many cases where it could not previously lie." Slip Op. (dissent) at 2. The dissent pointed out that *Salman* was "[a]n opinion considering a relationship between brothers" and so did "not need to rule on, or even address, how close two persons' friendship must be for them really to be 'friends.'" Id. at 16. Judge Pooler also noted that in *Salman*, the government urged, but the Supreme Court rejected, a more expansive theory of the personal benefit element under which "'a gift of confidential information to anyone, not just a 'trading relative or friend,' is enough to prove securities fraud.'" Slip Op. at 18.[3]

By grounding the personal benefit test in the tipper's "expectation that the tippee would trade" and the gift-giving analogy, the 'Martoma' majority has taken trial courts and, more importantly, juries, out of the business of evaluating the strength and nature of personal friendships as a basis for insider trading liability.

Implications of 'Martoma'

By grounding the personal benefit test in the tipper's "expectation that the tippee would trade" and the gift-giving analogy, the *Martoma* majority has taken trial courts and, more importantly, juries, out of the business of evaluating the strength and nature of personal friendships as a basis for insider trading liability. Whether or not the majority's test ultimately broadens the scope of insider trading liability, as the dissent fears, requiring juries to assess whether a particular friendship qualifies as "meaningfully close"—a standard that did not lend itself to bright lines—created the potential for arbitrary and inconsistent outcomes. What one person regards as "meaningfully close," another may view as merely a casual friendship. Is it relevant if the parties to the friendship viewed their relationship differently, in which case whose view of the relationship should prevail?

In the context of typical market communications between investors and company employees authorized to speak to the investment community, such as Investor Relations personnel or C-suite executives, the majority's opinion contains important safeguards. The majority expressly stated that disclosures for a corporate purpose, such as whistleblowing to reveal a fraud (as in *Dirks* itself), or "inadvertent disclosures," are "not disclosures made 'with the expectation that the [recipient] would trade on' them." Slip Op. at 29. And even if it could be argued that corporate spokespersons understand that the investors they talk to may trade, typical authorized communications between companies and investment professionals will not generally be sufficient to establish liability under

a quid pro quo or friendship analysis because the disclosure would not ordinarily "resemble trading by the insider followed by a gift of the profits to the recipient."

In this context, Regulation Fair Disclosure (FD), which requires issuers that selectively disclose material nonpublic information to promptly publish the information to the market, is also an important consideration. Absent facts suggesting that the disclosure was not part of the insider's normal responsibilities for communicating with the market, investors can reasonably assume that company spokespersons are authorized to make the disclosures they make or are providing information that has already been made public.

In this regard, the *Newman* case, which involved a rogue investor relations employee at Dell, has been frequently misconstrued as an effort by the government to criminalize routine market communications between companies and investors. The tipper in *Newman* provided Dell's company's unannounced top earnings numbers an analyst at Neuberger Berman at nights and on weekends for several quarters in a row. Neuberger Berman was a significant investor in Dell, but the tipper was not the primary liaison in Dell's IR Department for that investor. And in the quarter in which the downstream tippees made the most money, the information was negative (the portfolio managers took large short positions), and the head of IR sternly warned her team not to disclose the negative information. Moreover, none of the downstream tippees who traded knew that the tipper was in investor relations—they were told only that the source of the information was an insider at Dell.

The *Martoma* decision did not overturn a second, significant ruling in *Newman*, which provides additional protection for downstream tippees. *Newman* held that, in order for a downstream tippee to be found liable, the tippee must have knowledge of the fact that the original tipper received a personal benefit in exchange for the disclosures. This ruling was not at issue in *Martoma* or *Salman*. *Salman*, 137 S.Ct. at 425 n.1. However, it remains to be seen how the *Martoma* majority's focus on a gift-giving analysis will impact the government's burden in establishing a remote tippee's knowledge of the benefit at issue in the initial provision of inside information from the tipper to the tippee.

Conclusion

While the "expectation to trade" concept is not new to insider trading jurisprudence,[4] and is routinely included in jury instructions for the offense, the *Martoma* decision represents a significant development because it removes the additional hurdle for prosecutors imposed by *Newman*'s "meaningfully close personal relationship" requirement. Absent a rehearing en banc, which is unlikely given that only non-senior members of the circuit are eligible to vote for a rehearing, it will be left to lower courts to fully develop how or whether the court's gift-giving approach to personal benefit limits future insider trading prosecutions.

1. See, e.g., *SEC v. Obus*, 693 F.3d 276 (2d Cir. 2012) (tipper and tippee were college friends); *United States v. I*, 824 F.3d 5, 16 (1st Cir. 2016) (tipper and tippee were alleged to be "reasonably good friends" and tipper had an expectation that he would be treated to a golf outing and assorted luxury entertainment).

2. The majority countered that the same might be said for the "meaningfully close personal relationship" test. Slip Op. at 32 n.10.

3. The government in *Salman* had argued that the personal benefit test should focus on whether there was a corporate or non-corporate purpose to the disclosure, rather than on whether the tipper received a personal benefit. 137 S.Ct at 426-27. The court declined to adopt the government's proposal. Id.

4. See, e.g., *United States v. Gansman*, 657 F.3d 85, 92 (2d Cir. 2011) (the government must prove that the tipper conveyed the insider information to the tippee "with the understanding that it would be used for securities trading purposes").

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